UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

In re STATE STREET BANK AND TRUST CO. FIXED INCOME FUNDS INVESTMENT LITIGATION	MDL No. 1945
NING YU, On Behalf of Himself and All Others Similarly Situated, Plaintiff, vs. STATE STREET CORPORATION, et al., Defendants.	Civil Action No. 1:08-cv-08235-RJH (Relates to MDL No. 1945) CLASS ACTION

PLAINTIFF'S MEMORANDUM OF LAW IN OPPOSITION TO DEFENDANTS' MOTIONS TO DISMISS THE SECOND AMENDED CLASS ACTION COMPLAINT

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SECONDARY AUTHORITIES

Lead Plaintiff Anatoly Alexander ("Plaintiff" or "Alexander"), hereby responds to: (1) State Street Corporation's ("State Street") Memorandum of Law in Support of Motion to Dismiss Second Amended Class Action Securities Complaint [(the "SAC")] (Doc. #223) ("Def. Mem."); and (2) the Independent Trustees' Memorandum of Law in Support of Their Motion to Dismiss (Doc. #221) ("Trustee Mem."), both dated August 27, 2010.

I. INTRODUCTION

Plaintiff alleges that the Yield Plus Fund's (the "Fund") prospectus, registration statements, and related documents (collectively, the "Registration Statements"), contained untrue statements of material fact and omitted material information regarding the extent of the Fund's exposure to mortgage-related securities. The Court held in its July 14, 2010 opinion on Plaintiff's motion for reconsideration that Plaintiffs sufficiently stated a claim:

> But as plaintiff persuasively argues, "there is a world of difference between a Fund listing 14% [Mortgage-Backed Securities] with 'some' additional mortgage securities categorized as [Asset-Backed Securities], and a fund consisting of nearly 90% [mortgage-related securities]." If the allegations are true, the Fund may have amounted to an undiversified investment in the mortgage sector. . . . Thus, the PSAC states a plausible claim that the percentage tables mis-categorized securities and were materially misleading.

See Yu v. State Street Corp., No. 08 Civ. 8235 (RJH), 08 MDL No. 1945, 2010 WL 2816259, at *3 (S.D.N.Y. July 14, 2010) ("*Yu II*"). This Court's holding is now the law of the case.[1] So, while this Court invited defendants to bring a second motion to dismiss to address any unresolved issues, it did so with the following, unambiguous instruction: "The [second motion to dismiss] should ***not*** re-argue issues that have already been decided, *e.g.*, the sufficiency of the PSAC's allegations

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[1] *See Ovadia v. Top Ten Jewelry Corp.*, No. 04CIV2690RJHMHD, 2005 WL 1949970, at *1 (S.D.N.Y. Aug. 12, 2005) ("[I]f a court decided a rule of law, that decision should continue to govern in subsequent stages of the same case.").

concerning the percentage tables." *Id.* at *4.[2] As such, to the extent State Street's latest motion seeks to reargue this and other decided issues – which it does at length – it should be denied.

Plaintiff further pleads a plausible claim that defendants misrepresented that the Fund's investment objective was "to seek high current income ***and liquidity*** by investing ***primarily*** in a ***diversified portfolio*** of ***high-quality*** debt securities. . . ." ¶63.[3] Again, with nearly 90% of the Fund's holdings consisting of Mortgage-Backed Securities ("MBS"), or mortgage-related securities, and more than 26% of its holdings comprised of *subprime* MBS, the Fund was not diversified and was not "primarily" invested in high-quality debt securities. ¶¶73, 120-25, 134-40. In fact, in connection with related litigation, State Street management acknowledged that, during the Class Period, they were fully aware that the credit ratings associated with mortgage-related securities were no longer indicative of the securities' quality. ¶137. The Fund was, likewise, failing to seek – or, more importantly, maintain – liquidity. Indeed, defendants acknowledged that, by the summer of 2007, they knew that even AA-rated mortgage securities were "very illiquid." ¶¶126-33.

Plaintiff adequately alleges that the Fund's Registration Statements inaccurately represented that the Fund: (i) had meaningful diversification amongst sectors, and not as defendants argue, only with respect to individual issuers; (ii) was primarily invested in "high-quality" instruments, as the term is commonly understood; and (iii) was seeking liquidity in its investments. At minimum, these are inherent questions of material fact better left for the summary judgment stage. *Yu II*, 2010 WL 2816259, at *3.

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[2] Unless otherwise noted, all emphasis is added and all citations are omitted.

[3] "¶" refers to paragraphs in the SAC.

With respect to loss causation, the State Street defendants have now converted their original 3-page argument into a 9-page rendition of why every court that has considered and accepted the "materialization-of-risk" theory of causation was mistaken. Defendants contend that loss causation cannot exist in a federal securities mutual fund action absent proof that the fund's net NAV was misstated. According to defendants, even if every other statement in a registration statement is false and misleading, no private right of action can exist if the NAV may have been calculated correctly from a technical perspective. This argument has not been accepted by other courts recently addressing this issue and should likewise be rejected here. As Judge Scheindlin recently noted, "if a mutual fund holds itself out as investing no more than 25 percent in a single industry but then, as actually planned, invests fifty percent in a single industry, there is no escape by blaming the industry [upon its decline] rather than the promoter. The materialization of the concealed risk causes the loss."[4] Defendants, therefore, fail to meet their burden of establishing a negative causation defense at this juncture.

For the reasons set forth herein, Plaintiff respectfully requests that the Court deny defendants' motions to dismiss in their entirety.

II. BACKGROUND

Ning Yu initiated this securities class action, on June 30, 2008, by filing a complaint in the United States District Court for the District of Massachusetts. This case was later transferred to this Court via a MDL Panel Conditional Transfer Order dated September 4, 2008. Alexander, after being appointed lead plaintiff, filed his amended complaint on February 13, 2009. Defendants moved to

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[4] *King County, Wash. V. IKB Deutsche Industriebank, AG*, Nos. 09 Civ. 8387(SAS), 09 Civ. 8822(SAS), 2010 WL 1702196, at *5 (S.D.N.Y. Apr. 26, 2010) ("*IKB Deutsche*") (quoting *In re Charles Schwab Corp. Sec. Litig.*, No. 08 Civ. 1510 WHA, 2010 WL 1463490, at *6 (N.D. Cal. Apr. 8, 2010) ("*Charles Schwab II*")).

dismiss the complaint on March 11, 2009 and briefing on the motion was completed on April 20, 2009. On February 22, 2010, this Court issued an order dismissing the case "with prejudice." *See Yu v. State Street Corp.*, 686 F. Supp. 2d 369 (S.D.N.Y. 2010) ("*Yu I*"). Plaintiff timely requested, and this Court granted after full and extensive briefing, reconsideration of the "with prejudice" dismissal and further granted leave to file the SAC. *See Yu II*, 2010 WL 2816259. In its order, the Court considered and rejected defendants' arguments that amendment would be futile, specifically holding that Plaintiff stated a claim that the Registration Statements materially misrepresented the extent of the Fund's investment in mortgage-related securities. *Id.* at *3-*4.

> Here, the well-pleaded allegations are that defendants understated the mortgage-backed statistic-a statistic they found significant enough to include in the Annual Reports-by more than 100%. That misstatement is not "so obviously unimportant" as to warrant dismissal of claims premised thereon. Secondly, plaintiff now alleges that mortgage-related securities as a whole represented 87% of the Fund's portfolio at a time when the Annual Report stated that mortgage backed securities represented only 13.8% of the Fund. In light of this addition, the PSAC states a plausible claim that the Annual Report materially misled investors by disclosing that a specific type of mortgage-related security represented only a small portion of the portfolio, while at the same time failing to disclose that the Fund invested nearly all of its assets in mortgage-related securities of some sort. . . . [A]s plaintiff persuasively argues, "there is a world of difference between a Fund listing 14% [Mortgage-Backed securities] with 'some' additional mortgage securities categorized as [Asset-Backed securities], and a fund consisting of nearly 90% [mortgage-related securities]." If the allegations are true, the Fund may have amounted to an undiversified investment in the mortgage sector. . . . ***Thus, the PSAC states a plausible claim that the percentage tables mis-categorized securities and were materially misleading.***

Id. at *3. The Court afforded defendants the opportunity to raise issues not already addressed, but specifically directed that the parties not re-argue this or other decided issues. *Id.* at *4.[5]

[5] The Court expressed no opinion as to whether the SAC stated a claim that the Fund did not contain "high quality" investments, as represented. *Id.* at *4 n.4. The Court also found the misvaluation claims could not be sustained. *Id.*

III. SUMMARY OF ALLEGATIONS

Defendants began offering Fund shares with the filing of a registration statement in late 1992, and filed similar registration statements, prospectuses and related documents throughout the Class Period. ¶¶29-33; *see also* ¶1 (alleging Class Period of 7/1/05 through 6/30/08). Defendants marketed the Fund to investors as an alternative to a money market fund and compared its returns to those of the J.P. Morgan 3-month LIBOR Index. ¶60. The Registration Statements described the Fund as follows:

> Yield Plus Fund. The nonfundamental investment objective is to seek high current income ***and liquidity*** by investing ***primarily*** in a ***diversified portfolio*** of ***high-quality*** debt securities and by maintaining a portfolio duration of one year or less.
>
> The Fund attempts to meet its objective by investing primarily in high-quality, dollar-denominated debt instruments, such as mortgage related securities, corporate notes, variable and floating rate notes and asset-backed securities. The Fund may also invest in derivative securities, including interest rate swaps, credit default swaps, total return swaps, interest rate caps, floors and collars, futures, options, and other structured securities.

¶¶62-63.

A list of the securities held by the Fund was disclosed in certain Registration Statements, such as the Annual Reports, Semi-Annual Reports and Form N-Qs. The securities are categorized into various underlying sectors, ¶¶64-65, including "Asset-Backed Securities [ABS],"[6] "Mortgage-Backed Securities [MBS],"[7] "Corporate Bonds and Notes," and "International Debt." ¶64. The Registration Statements further represented the percentage of allocated investments in each sector of

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[6] The Registration Statements defined ABS as "collateralized pools" of an assorted array of assets such as "auto loans, credit card receivables, leases, installment contracts and personal property." ¶66.

[7] The Registration Statements defined MBS as pools of "mortgage loans evidenced by promissory notes secured by first mortgages or first deeds of trust or other similar security instruments creating a first lien on owner occupied and non-owner occupied" properties. ¶67.

the Fund. As of May 31, 2007, for example, the Fund was represented as consisting of 60.4% ABS, 24.8% International Debt and 14% MBS. ¶73.

Defendants' representations regarding the Fund, however, were false and misleading when made. Unbeknownst to investors, the Fund was an unsafe and risky bet, concentrated on real estate and the securities that funded it in the midst of the mortgage meltdown. State Street's own internal documents identified, as of the May 31, 2007 time-frame, 87% of the Fund's portfolio as MBS; not the 14% that was represented to the investing public. ¶¶71, 73-74. More disturbing, investors were not privy to the fact that nearly 27% of the overall portfolio consisted of *subprime* mortgage securities. ¶¶73-74. Defendants' description of the Fund as invested in a "diversified portfolio" of "high-quality" debt securities was similarly false and materially misleading. With 87% of the Fund's investments held in mortgage-related securities, coupled with the significant holdings of mortgage-related securities in the ABS and International Debt sectors, the Fund could not claim to be diversified. ¶¶73-74, 97, 103, 119-25. And, with more than a quarter of its overall holdings invested in *subprime* mortgage-related securities, the Fund was clearly not invested in "high-quality" securities. ¶¶73-74, 134-40. Indeed, State Street management now acknowledges they were internally aware that the ratings assigned by agencies had ceased to provide a meaningful assessment of the quality of the Fund's mortgage-related securities. ¶137. They further recognized, internally, that even the Fund's AA-rated holdings had become severely illiquid. ¶128. Yet, defendants failed to relay this essential information to investors; instead, they publicly represented otherwise.

Ultimately, the Fund's undisclosed risks materialized and investors suffered dramatic losses. ¶¶149-51. The Fund's NAV plummeted from $9.96 per share at the beginning of the Class Period to $6.60 per share on May 21, 2008 – a loss of almost 34% – before the Fund was liquidated in May 2008. ¶¶150, 158. Analysts (and State Street itself) agreed that the Fund's losses were caused by its

previously-undisclosed concentration in MBS, subprime MBS and other mortgage-related securities. ¶¶152-54. Notably, the ultra-short funds that did not surreptitiously concentrate their assets in dicey real estate bets fared much better and were not forced into drastic reductions of their NAVs or, worse, into liquidation. ¶152.

IV. ARGUMENT

A. The Standard Governing Defendants' Motions to Dismiss

When evaluating a Fed. R. Civ. P. 12(b)(6) motion to dismiss, a court must construe the complaint liberally, accept all well-pleaded factual allegations as true and draw all reasonable inferences in the plaintiff's favor. *Yu I*, 686 F. Supp. 2d at 373. Dismissal is only appropriate if the plaintiff fails to provide factual allegations sufficient to "raise a right to relief above a speculative level" to being "plausible." *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 555, 559 (2007) ("*Twombly*"). "'A claim has facial plausibility when the plaintiff pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged.'" *Yu I*, 686 F. Supp. 2d at 373 (quoting *Ashcroft v. Iqbal*, 129 S. Ct. 1937, 1949 (2009)). This standard is "flexible," only "oblig[ing] a pleader to amplify a claim with some factual allegations in those contexts where such amplification is needed to render the claim plausible." *Levine v. AtriCure, Inc.*, 594 F. Supp. 2d 471, 474 (S.D.N.Y. 2009) ("*AtriCure II*").[8]

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[8] Section 11 imposes liability on, *inter alia*, the issuer of a security, as well as any person who signed the registration statement and/or served as a director of the issuer or performed similar functions, for a registration statement that contains a false or misleading statement of material fact, or omits a material fact that is required to be stated or is "necessary to make the statements therein not misleading." *Yu I*, 686 F. Supp. 2d at 374. "Section 12(a)(2) creates the same liability" for anyone who "offers or sells a security" by means of a "prospectus or oral communication." *Id.* To establish a *prima facie* claim under Section 11, a plaintiff "'need only plead a material misstatement or omission in the registration statement.'" *Levine v. AtriCure, Inc.*, 508 F. Supp. 2d 268, 272 (S.D.N.Y. 2007) ("*AtriCure I*") (quoting *In re Flag Telecom Holdings, Ltd. Sec. Litig.*, 411 F. Supp. 2d 377, 382 (S.D.N.Y. 2006)). Under Section 11, an issuer's liability for even innocent

B. The Fund's Registration Statements Were Untrue, Misleading and Omitted Material Information in Violation of the Securities Act of 1933

1. The Court Already Held that Defendants' False and Misleading Disclosures Regarding the Extent of the Fund's Mortgage-Related Securities Holdings Are Actionable

The Court has unequivocally held that "the PSAC states a plausible claim that the percentage tables mis-categorized securities and were materially misleading." *See Yu II*, 2010 WL 2816259, at *3. This is the law of the case. *See Ovadia*, 2005 WL 1949970, at *1. Despite the Court's clear instruction not to re-argue issues previously decided, the State Street defendants rehash arguments that have already been rejected; specifically, the materiality of the false percentage tables in the Registration Statements. *See* Def. Mem. at 2-3, 18-22. Defendants' argument amounts to an improper motion for reconsideration of the Court's order and should be stricken. *See* Def. Mem. at 18 n.11 ("State Street respectfully moves the Court to Reconsider its July Opinion.").[9]

2. The Fund's Stated Investment Guidelines Were Materially False and Misleading

Defendants represented that the Fund would "seek high current income and liquidity by investing primarily in a diversified portfolio of high-quality debt securities. . . ." ¶63. As alleged in detail in the SAC, defendants misrepresented that the underlying investments would consist "primarily" of a "diversified portfolio" of "high-quality" debt securities. The Fund's portfolio,

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misstatements is "virtually absolute," while all other defendants "may be held liable for 'mere negligence.'" *In re CitiGroup Inc. Bond Litig.*, No. 08 Civ. 9522 (SHS), 2010 WL 2772439, at *15 (S.D.N.Y. July 12, 2010) (Section 11 is designed to "assure compliance" with the Securities Act by "imposing a stringent standard of liability" on defendants and placing a "relatively minimal burden on a plaintiff.").

[9] Should the Court entertain defendants' request to reconsider the Court's "reconsideration order" granting leave to re-plead, Plaintiff requests an opportunity to fully respond to these renewed arguments.

however, was not diversified and not invested in high-quality securities, as defendants increasingly invested in undisclosed, risky mortgage-related and subprime securities during the Class Period. ¶70.[10] Although this Court initially dismissed Plaintiff's allegations related to the foregoing investment objective, it was because there were insufficient facts to infer falsity; facts and details that the SAC has since remedied. *See Yu I*, 686 F. Supp. 2d at 377.

As an initial matter, the Fund's investment objective was not a "general statement of aspirational goals," as characterized by defendants, but instead delineated key, objective guidelines and ground rules for the Fund's overall investment strategy. *In re Evergreen Ultra Short Opportunities Fund Sec. Litig.*, 705 F. Supp. 2d 86, 92 (D. Mass. 2010) ("the statements in the Fund's prospectuses were more than mere aspirations or avowals of the Fund's goals. Rather, they were key guidelines that established the Trust's investment strategy and laid down the basic ground rules it would follow."). The Fund did not, as represented, seek "high current income" "by investing

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10 Defendants' claim that Plaintiff impermissibly relies on hindsight allegations to demonstrate the plausibility of his allegations is simply not true. *See* Def. Mem. at 10-11, 14, 19-22. Instead, he not only lists external indicators, but also alleges that defendants had contemporaneous internal information that they failed to disclose concerning the Fund's unprecedented concentration in MBS and subprime MBS, the low quality of these investments, and the associated rating and liquidity problems. *See also In re MoneyGram Int'l, Inc. Sec. Litig.*, 626 F. Supp. 2d 947, 980 (D. Minn. 2009) (external market indicators that are connected to defendants' "internal recognition of the effect of those red flags on the Portfolio's securities throughout the class period . . ." support a finding that representations were "false *at the time they were made* and omissions should have been disclosed earlier in light of the then-existing facts"); *In re Charles Schwab Corp. Sec. Litig.*, 257 F.R.D. 534, 542 (N.D. Cal. 2009) ("*Charles Schwab I*") (based on a similar class period, plaintiffs stated a claim by alleging that a fund concentrated a significant portion of its portfolio in mortgage-backed securities, "investors were unwittingly exposed to significant risks, and as the nation's credit crisis unfolded, those risks lead to substantial losses."). Notably, defendants' cases are inapposite. *See N.J. Carpenters Vacation Fund v. Royal Bank of Scotland Group, PLC*, No. 08 CV 5093 (HB), 2010 WL 1172694, at *14 (S.D.N.Y. Mar. 26, 2010) (plaintiffs failed to allege statements were false at the time made); *Landmen Partners, Inc. v. Blackstone Group, L.P.*, 659 F. Supp. 2d 532, 544 (S.D.N.Y. 2009) (complaint failed to allege any facts linking defendants' investments with the problems in the subprime market, and failed to establish "known trends" as required by a regulation not at issue here).

primarily in a diversified portfolio of high-quality debt securities." ¶63; *contrast Hunt v. Alliance N. Am. Gov't Income Trust, Inc.*, 159 F.3d 723, 731 (2d Cir. 1998) (Def. Mem. at 12) (fund's subjective and vague investment objective to "seek the highest level of current income, consistent *with what the Fund's Adviser considers* to be prudent investment risk" not actionable).[11] Defendants' failure to adhere to the Fund's own ground rules without appropriate disclosure resulted in the additional material misrepresentations and omissions in the Registration Statements. *See Evergreen*, 705 F. Supp. 2d at 92 (finding that the investment objective, considered in context, was actionable: "the statements in the offering materials made distinct claims about the posture of the Fund, its investment strategies and the rules under which it would operate").[12]

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[11] For this reason, defendants' cases are distinguishable. *See, e.g.*, *In re TCW/DW N. Am. Gov't Income Trust Sec. Litig.*, 941 F. Supp. 326, 338 (S.D.N.Y. 1996) (Def. Mem. at 12) (finding investment objective of "'earn[ing] a high level of current income while maintaining relatively low volatility of principal'" did not make a specific promise to investors, and distinguishing this statement from more specific characterizations of securities, as present in this case, that may be important to a reasonable investor); *but see In the Matter of Piper Capital Management, Inc.*, S.E.C. Release No. 175, 2000 WL 1759455, at *32 (Nov. 30, 2000) (attached hereto as Ex. 1) ("[Fund] management strategies and techniques promoted the 'high level of current income' component of [the fund's] stated investment objective at the expense of the 'consistent with preservation of capital' component, thereby subverting the Fund's *overall* investment objective.").

[12] *See also In re American Int'l Group, Inc. 2008 Sec. Litig.*, Master File No. 08 Civ. 4772(LTS), 2010 WL 3768146, at *15 (S.D.N.Y. Sept. 27, 2010) (finding failure to disclose the scope of AIG's exposure to RMBS to be actionable). Plaintiff further notes that the undisclosed fact that 26%+ of the Fund was *subprime* MBS, despite a representation that there was only 14% total MBS in the Fund, in the midst of the mortgage meltdown, serves to highlight the materiality and misleading nature of defendants' disclosures. *See* ¶¶43-56, 59, 73. Similarly, defendants' claim that reasonable investors would not find material the fact that the Fund was overwhelming concentrated in a single, risky and volatile sector – that is, MBS – is simply absurd. *See* Def. Mem. at 18-22. And even if these investments were not themselves recognized as risky during the Class Period (which they clearly were), the objective of a diversified portfolio is to reduce overall risk. *See, e.g.*, www.investorwords.com (definition of "diversification," "The goal of diversification is to reduce the risk in a portfolio.").

a. The Fund's Debt Security Investments Were Not "Diversified"; Instead They Were Overwhelmingly Concentrated in MBS and Subprime MBS

Defendants represented that the Fund would invest primarily in a "diversified portfolio" of high-quality debt securities. ¶63. Defendants reinforced this false statement by misrepresenting the allocation of the Fund's assets amongst the various sectors. *Yu II*, 2010 WL 2816259, at *3. As this Court previously recognized, the SAC states a "plausible claim that the percentage tables mis-categorized securities and were materially misleading," and that "[i]f the allegations are true, the Fund may have amounted to an *undiversified* investment in the mortgage sector, and the narrow disclosure of the percentage of 'mortgage-backed' investments arguably misled investors about that fact." *Id.* at *3. The Court was absolutely correct in its conclusion and should not reconsider its holding like defendants seek here.

For example, as of May 31, 2007, the Fund was reportedly comprised of 60.4% ABS, 24.8% International Debt, 14% MBS and 0.8% Short-Term Investments. ¶73. Although more than half the Fund consisted of ABS debt securities, "ABS" itself was represented as "collateralized pools" of a diverse array of assets such as "auto loans, credit card receivables, leases, installment contracts and personal property." ¶66. They did not disclose that almost 90% of the Fund's assets were concentrated in MBS. ¶¶71, 73-74. Accordingly, defendants stated that the Fund was less risky than represented since it disclosed that the Fund was still "investing primarily in a diversified portfolio of high-quality debt securities." ¶¶119-25.[13] *See Sonnenberg v. Prospect Park Financial Corp.*, No. Civ. 91-435(DRD), 1991 WL 329755, at *9 n. 5 (D.N.J. Aug. 20, 1991) ("The purpose of the federal

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[13] This is true despite the "sector risk" disclosure cited by defendants because their categorization of the Fund's securities concealed that the true extent of the risk and undiversified nature of the Fund, and there was no way to determine from the Registration Statements that the Fund's investments were overwhelmingly concentrated in the faltering real estate market.

securities laws is to ensure that investors have sufficient information to assess and avoid undue risks by refraining from purchasing securities that carry greater risks than the investor is willing to bear."); *see also* www.investorwords.com (definition of "diversification," "The goal of diversification is to reduce the risk in a portfolio.").

In support of their argument, defendants point to the Statement of Additional Information (the "SAI"), dated December 18, 2006 (Skinner Decl., Ex. B),[14] for the definition of the term "diversified." *See* Def. Mem. at 17-18. There, in the section describing the investment strategies and principal risks of the twenty-four listed SSgA funds,[15] including the Fund, the SAI states that "[t]he SSgA Funds are an open-end investment management company, *diversified* as defined in the Investment Company Act of 1940." Based on this appearance of the word "diversified" in the SAI, which is wholly unrelated to the allegations of the SAC, defendants assert that Plaintiff cannot allege that the use of this term was false and misleading. *See* Def. Mem. at 17-18. Defendants argue that Plaintiff fails to allege that the Yield Plus Fund was not diversified under the corresponding definition for "diversified" as established by the 1940 Act. Defendants miss the point. The issue is not how "diversified" is defined in the 1940 Act, because the term "Diversified Portfolio," as it is

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[14] "Skinner Decl., Ex. ____" refers to exhibits to the Declaration of Robert A. Skinner in Support of State Street's Motion to Dismiss Second Amended Class Action Securities Complaint (Doc. #224).

[15] (1) SSgA Money Market Fund; (2) SSgA US Government Money Market Fund; (3) SSgA Tax Free Money Market Fund; (4) the Yield Plus Fund; (5) SSgA Intermediate Fund; (6) SSgA Bond Market Fund; (7) SSgA High Yield Bond Fund; (8) SSgA Core Opportunities Fund; (9) SSgA S&P 500 Index Fund; (10) SSgA Disciplined Equity Fund; (11) SSgA Small Cap Fund; (12) SSgA Enhanced Small Cap Fund; (13) SSgA Aggressive Equity Fund; (14) SSgA IAM SHARES Fund; (15) SSgA Large Cap Value Fund; (16) SSgA Large Cap Growth Opportunities Fund; (17) SSgA Directional Core Equity Fund; (18) SSgA Tuckerman Active REIT Fund; (19) SSgA Emerging Markets Fund; (20) SSgA International Stock Selection Fund; (21) SSgA International Growth Opportunities Fund; (22) SSgA Life Solutions Income and Growth Fund; (23) SSgA Life Solutions Balanced Fund; and (24) SSgA Life Solutions Growth Fund.

used in the objection of the Fund, is different than how the term "diversified" is used elsewhere in the SAI.

Plaintiff alleges that the stated objective of the Fund ***itself*** – not the more general definition of ***all*** SSgA Funds – is to invest primarily in a "diversified portfolio." ¶63. The description of the Fund's diversified portfolio openly refers to the strategy of investing in a wide variety of opportunities for the purposes of reducing the risk of large losses by investing in a single security or individual industry. This distinction between "diversified" under the 1940 Act and "Diversified Portfolio" in the description of the Fund is further shown by the fact that the SAI states that the Fund meets its objective by spreading its assets among a variety of securities or strategies, including, for example, "mortgage related securities, corporate notes, variable and floating rate notes and asset-backed securities." ¶125; *see* Skinner Decl., Ex. B at 4. Clearly, the use of the word "diversified" in the Fund's description refers to this method of risk reduction, and not to a defined term under the 1940 Act. *See Piper Capital*, 2000 WL 1759455, at *24 (Ex. 1) (rejecting defendant's technical definition of "diversified" where, as here, the language utilized in the fund's own registration statements "impl[ied] diversification in the familiar sense.").[16]

Furthermore, defendants cannot credibly argue that the use of the term "diversified portfolio" in the description of the Fund itself merely refers back to the SAI's overall description of the SSgA Funds. *See* Def. Mem. at 17. Indeed, only two of the twenty-four SSgA Funds – the Yield Plus Fund and the SSgA Intermediate Fund – use the term "diversified portfolio" as part of their investment objectives and principal investment strategies descriptions. *See* Skinner Decl., Ex. A, at

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[16] Also, whether a reasonable investor would interpret "diversified" under a commonly accepted meaning, or under the exceedingly narrow definition proffered by defendants is, at minimum, a question of fact.

4-5.[17] As such, the "diversified portfolio" descriptor associated with these two funds was undoubtedly intended to add something beyond the 1940 Act's definition of "diversified." Because the Fund was not "investing primarily in a diversified portfolio" of debt securities during the Class Period, the statements in the Registration Statements to the contrary were false and misleading at the time they were made.

b. The Fund's Investments Were Not "Primarily" in "High-Quality Debt Securities"; They Were Overwhelmingly Concentrated in Low-Quality MBS and *Subprime* MBS

The Fund's significant debt security holdings, in contrast to the representations made in the Registration Statements, were not of "high quality." Plaintiff has now stated a claim for this false statement and addressed the prior concerns set forth by this Court in the *Yu I* opinion. Specifically, the Court previously found that the term "high quality" appeared to refer to the securities being rated "investment grade," and that Plaintiff had not alleged any facts suggesting that this was not the case. *See Yu I*, 686 F. Supp. 2d at 376; *see also id.* ("[the complaint] does not say, for example, to what extent those [mortgage-related] securities . . . were backed by subprime loans, as opposed to loans to credit-worthy corporate or individual borrowers; nor does it include other facts by which the 'quality' of the mortgage-related holdings might be judged.").

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[17] In contrast, the description of The Tuckerman Active REIT Fund, another of the SSgA Funds, states it is "non-diversified" and, in doing so, specifically states that it is non-diversified as defined by the Investment Company Act of 1940. *See* Skinner Decl., Ex. A, at 12. Notably, the description of the Fund (and the SSgA Intermediate Fund) does not reference or define the "diversified" or "non-diversified" nature of the funds to be "as defined by the Investment Company Act of 1940." Clearly, the description of the Fund's "diversified portfolio" refers to the plain meaning of the term – that is, the strategy of investing in a variety of opportunities in order to reduce the risk of large losses associated with investing in a single security or individual industry.

The SAC, however, now contains allegations, including deposition testimony from the MDL Action, that State Street management was aware, no later than the summer of 2007, that the "ratings associated with mortgage-related securities were not indicative of their quality and that there was information to lead one to question the ratings on those securities." ¶137. Therefore, they recognized that in order to evaluate the securities' overall quality, management could not rely solely on a bond's rating because not all "AAA" rated debt securities are of equal soundness. ¶138. What is worse, more than a quarter of the Fund's holdings were a subset of MBS, that is, *subprime* MBS, which by mid-2006 were widely recognized as risky, unsecure and of low quality. ¶¶42, 48-59, 135; *CitiGroup*, 2010 WL 2772439, at *21 (finding representations that company's mortgage-backed assets were of "high credit quality" were untrue when made because information was available to defendants to the effect that the assets were backed by subprime mortgages and "were therefore not of 'high credit quality.'"); *IKB Deutsche*, 2010 WL 1702196, at *7 n. 55 ("subprime mortgages are considered among the riskiest category of consumer loans"); *see also Yu I*, 686 F. Supp. 2d at 377 (finding that plaintiff did not "plead that the Fund's holdings fell within an especially risky, 'low-quality' subset of the mortgage-related sector.").[18]

By the beginning of the Class Period, there were also external market indicators suggesting that MBS, and subprime MBS in particular, were increasingly unstable and risky. The SAC alleges that State Street management discussed the increased risk in mortgage-related and MBS and the "imminent threat of a complete meltdown in the industry" by at least early 2007. ¶¶43-59, 136-38;

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[18] The *CitiGroup* court further held that "[t]o the extent defendants seek to argue that those subprime mortgages and subprime RMBS were actually of 'high credit quality,' they cannot do so on this motion to dismiss where, of course, the Court is limited to the allegations, taken as true, as set forth in the complaint." *CitiGroup*, 2010 WL 2772439, at *21.

see MoneyGram, 626 F. Supp. 2d at 980. Defendants also closely monitored quality-related metrics of the Fund's MBS holdings throughout the Class Period.[19]

With respect to defendants' claim that "high-quality" simply referred to credit grades assigned by national ratings agencies, which defendants claim they relied upon, the Second Circuit's opinion in *Franklin Savings Bank of N.Y. v. Levy*, 551 F.2d 521, 522, 527 (2d Cir. 1977), is instructive. Def. Mem. at 13; Trustee Mem. at 6. In *Franklin Savings Bank*, Goldman Sachs represented that commercial paper it dealt for the issuer, Penn Central Transportation, was "credit worthy" and "high quality." *Franklin Savings Bank*, 551 F.2d at 527 (2d Cir. 1977). After Penn Central Transportation filed for bankruptcy, investors sued, among other things, for violations of the Securities Act. *Id.* at 523. The court held:

> If Goldman Sachs failed to exercise reasonable professional care in assembling and evaluating the financial data, ***particularly in view of the worsening condition of Penn Central, then its representation that the paper was credit worthy and high quality was untrue in fact and misleading no matter how honestly but mistakenly held***. This view does not render Goldman, Sachs an insurer as appellants claim liable for some catastrophe beyond its control. Rather, it in fact makes the dealer responsible to Franklin if it is unable to shoulder the burden of establishing that it was not reasonable for it to have determined on March 16, 1970 that the quality of the paper it was purveying was less than that represented.

Id. at 527. The same analysis applies here. Defendants cannot shield themselves behind the credit rating agencies since they knew the assigned ratings were no longer indicative of the actual quality of the Fund's mortgage-related securities.[20]

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[19] For instance, State Street's internal analytics, as of mid-2006, meticulously separated the Fund's mortgage-related securities into categories that have different risks, stabilities and credit characteristics. *See* ¶73 (categories included "Home Equity," "Mortgage-Backed Securities – Aussie," "Mortgage-Backed Securities – UK," "Mid-Prime MBS," "Prime MBS" and "Subprime MBS").

[20] Defendants should not escape liability for their own misleading statements, regardless of whether the ratings industry was able to "keep abreast of the burgeoning debt market crisis." *See*

The Registration Statements disclosed that the Fund's portfolio consisted primarily of high credit quality, investment grade securities. To the contrary, the Fund was, in fact, overwhelmingly invested in MBS and subprime MBS. Defendants knew that the MBS and, in particular, the subprime MBS had low (or, at a minimum, questionable) quality. Plaintiff, therefore, has stated a claim for these additional misrepresentations. *See also F.W. Webb Co. v. State Street Bank and Trust Co.*, No. 09 Civ. 1241 (RJH), 2010 WL 3219284, at *11 (S.D.N.Y. Aug. 12, 2010) (finding plaintiffs stated a claim that defendants breached their fiduciary duty by making material misrepresentations when they represented the Yield Plus Fund as a "safe, conservative investment, tantamount to a money market fund" but "[i]n actuality . . . was . . . a highly risky fund that invested mainly in low quality mortgage-backed investments").

c. Defendants Misrepresented the Fund's Investment Objective Because the Securities It Held Were Not "Liquid"

Defendants represented that the Fund would "seek high current income and liquidity." ¶¶63, 126. While defendants may still have been seeking high current income with their risky mortgage-related bets, they did not maintain their objective of seeking "liquidity." ¶¶126-33. The SAC specifically alleges defendants acknowledged internally, at least by summer of 2007, that the Fund was subject to a material liquidity risk such that "even the AA rated mortgage-related securities were 'very illiquid.'"[21] ¶128; *see also* ¶¶43-59, 131 (alleging that the extensive reporting of the

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Def. Mem. at 14. Given the factual allegations that State Street was internally aware that a significant amount of the Fund's investments were not high quality at least by early 2007, *Phillips v. Kidder, Peabody & Co.* is inapplicable. 933 F. Supp. 303, 320 (S.D.N.Y. 1996) (only evidence of slowing computer industry was two newspaper reports).

[21] This time period was *prior* to defendants' admission that the higher rated securities held by the Fund had experienced illiquidity. *See* Trustee Mem. at 4. Nevertheless, defendants still concealed the Fund's true exposure to mortgage-related securities and reinforced the false perception

broadening mortgage crisis during the Class Period should have been sufficient indicators of the increasing liquidity risk in the Fund for defendants, who were the only ones aware of the huge proportion of mortgage-related securities in the Fund). Then, in November 2007, a source within the Fund indicated that the Fund had been "impacted" by its severely illiquid holdings. ¶129. It was not until December 2007, however, that defendants belatedly disclosed the Fund's "liquidity risks." ¶130. And, when they did, the description of these risks referred to the Fund's ***underlying holdings***, particularly with respect to ABS and MBS. *Id.* Thus, defendants' representation that the Fund sought liquidity during the Class Period was unmistakably false and misleading at the time it was made (and also served to further conceal the true risk of the Fund). ¶133; *see also Evergreen*, 705 F. Supp. 2d at 93 (reasoning that the dispute as to illiquidity may not be resolved on a motion to dismiss as plaintiffs stated a claim that defendants invested in illiquid securities based on allegations concerned the inherent illiquidity of the securities at issue).

Notably, defendants have not cited to anything in the Registration Statements that supports their overly restrictive interpretation of "liquidity." Although defendants refer to page 4 of the Prospectus (*see* Def. Mem. at 14-16; *id.*, Skinner Decl., Ex. A at 4; Trustee Mem. at 5), the only mention of "liquidity" is in the investment objective itself. Moreover, the "sector risk" disclosure upon which defendants rely actually supports Plaintiff's interpretation. *See* Def. Mem. at 16; *id.*, Skinner Decl., Ex. A at 19 ("*Securities* of issuers held by [the Fund] may lack sufficient *market*

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that the Fund held primarily "high credit quality" securities that only experienced price depreciation due to what defendants essentially characterized as a temporary market occurrence with investors selling these securities at the same time. *See* Skinner Decl., Ex. D at 6. Indeed, these statements created a duty of complete and accurate disclosure of the Fund's mortgage-related holdings and the attendant risks. *CitiGroup*, 2010 WL 2772439, at *19.

liquidity . . .").[22] Defendants also assert that "[t]he relative liquidity of YPF's securities can be meaningfully assessed only against the type of instruments in which the Fund was permitted to invest." Def. Mem. at 15. In support of this proposition, they arbitrarily list types of investments that were, according to defendants, more liquid, but did not constitute a significant part of the Fund's portfolio. *See id.* But defendants miss the point. Defendants invested in a manner such that the vast majority of the Fund's holdings were (as disclosed in State Street's internal analytics, but not the Registration Statements) in mortgage-related securities, with significantly diminished liquidity. ¶¶127-29, 131. Defendants were well aware of this significant and growing liquidity risk, but failed to remedy it or otherwise update and correct their disclosures. ¶128. Accordingly, defendants' failure to disclose their complete and surreptitious abandonment of the Fund's investment objective is actionable under the federal securities laws. *See In re MBIA Sec. Litig.*, No. 08-cv-264(KMK), 2010 WL 1253925, at *10 (S.D.N.Y. Mar. 31, 2010); *Evergreen*, 705 F. Supp. 2d at 93.

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[22] The "sector risk" disclosure cited by defendants fails to remedy their misleading statements. ¶63. The disclosure was essentially meaningless considering the Registration Statements did not accurately reflect the Fund's exposure to MBS. Indeed, there was no way to glean from the information provided that the "sector risk" referred to exposure to the mortgage industry. *See* Skinner Decl., Ex. A at 19 (referring generically to a risk of investment concentration in "specific industry sectors" that may affect the liquidity of the Fund, without identifying the industry). Tellingly, when defendants finally disclosed the Fund's "Liquidity Risk" in December 2007, they explicitly included "asset-backed securities and mortgage-backed securities" among the securities "subject to the risk that [they] may not be sold at the quoted market price within a reasonable period of time." ¶130. It is tantamount to generic disclosures discussed in other cases in which the registration statement provides an investment objective, and then states there is a risk the Fund may not achieve that objective. *See, e.g., Hines v. ESC Strategic Funds, Inc.*, No. 3:99-0530, 1999 WL 1705503, at *10 (M.D. Tenn. Sept. 17, 1999); *Evergreen*, 2010 WL 1253114, at *5. Courts have generally found such disclosures insufficient because they do not address the specific risk to which the Fund is subject, and forward-looking disclosures are insufficient to address risks that have already materialized, as in this case. *Id.*; *In re Prudential Sec. Inc. Ltd. P'ship Litig.*, 930 F. Supp. 68, 72 (S.D.N.Y. 1996); *In re Westinghouse Sec. Litig.*, 90 F.3d 696, 709-10 (3d Cir. 1996).

In the end, the terms "diversified portfolio," "high-quality" and "liquidity" must be judged in context and based on the perspective of a reasonable investor. But the Registration Statements simply do not support defendants' narrow interpretations. *See In re Charles Schwab Corp. Sec. Litig.*, No. C08-01510 WHA, 2010 WL 1463490, at *3 (N.D. Cal. April 8, 2010) (finding defendants' interpretation "extreme" on a summary judgment motion where it was, as here, "directly at odds with the otherwise clear-cut representations" made by the fund). Because Plaintiff's interpretations "sit[] comfortably within the realm of possibility," and the statements' falsity is supported by factual allegations, any doubt should be resolved in Plaintiff's favor at this stage. *Twombly*, 550 U.S. at 593.

3. Plaintiff Adequately Alleges Misrepresentations in the Certifications of Defendants Ross and Swanson

Defendants continue to claim that there are simply no facts to support the allegation that "the certifications signed by [defendants] Ross and Swanson" contained untrue "statements of material fact." *See* Def. Mem. at 9 n.9 (incorporating arguments related to Ross's and Swanson's certifications from defendants' previous motion to dismiss); *see also* ¶¶146-48 (setting forth the alleged misstatements). Yet, this Court has already found that defendants made false statements of material fact regarding the Fund's mortgage-related holdings, which alone supports the false or misleading nature of the certifications. *Yu II*, 2010 WL 2816259, at *3. Additionally, as discussed above, defendants further misrepresented that the Fund would maintain a "diversified portfolio" and invest in "high quality" securities in seeking current income and "liquidity." *See* ¶¶16, 18, 73-79, 128, 137, 147-48 (alleging that these defendants at minimum should have known of various misstatements). Accordingly, Plaintiff adequately pleads the certifications were materially false or misleading, as well.

C. Plaintiff Adequately Pleads a Section 12(a)(2) Claim Against State Street, SSgA, Leahy, Ross, Swanson and the "Independent Trustees" as Statutory Solicitors

Under Fed. R. Civ. P. 8(a), a plaintiff needs only plead statutory solicitor status generally. *Westinghouse*, 90 F.3d at 717.[23] Here, Plaintiff has more than adequately pled that defendants engaged in the solicitation of the sales. *Charles Schwab I*, 257 F.R.D. at 548-50 (finding that liability under Section 12 is not limited to those who actually pass title to the security; rather, it extends to certain persons who engage in the solicitation of the sales). In addition to alleging that defendants Leahy, Ross, Swanson and the Independent Trustees signed the Registration Statements,[24] Plaintiff alleges facts to support defendants' positions as statutory solicitors. *See* ¶¶11-20. For example, the SAC alleges that defendants began offering shares of the Fund "pursuant to an initial registration statement, filed with the SEC," that defendants "marketed" the Fund and "issued and offered for sale shares of the Fund," that defendants were "sellers and offerors and/or solicitors of purchasers of the shares of the Yield Plus Fund" and that defendants "participat[ed] in the preparation of the false and misleading Registration Statements." ¶¶29, 60, 69, 175, 176, 177. What is more, the SAC alleges that each Independent Trustee had a position on the Board of Trustees of SSgA Funds, (*see* ¶¶11, 13-15, 17, 19, 22), and that as Board members, they were responsible for "overseeing generally the management, activities and affairs of each fund," and were "sellers and offerors and/or solicitors of purchasers of the shares of the Yield Plus Fund." ¶¶9, 11,

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[23] Plaintiff adopts the arguments presented to this Court on this issue in his memorandum of law in opposition to defendants' first motion to dismiss, dated April 6, 2009 (pages 26-29), and submits further opposition on this legal issue only to the extent that defendants raised further authority in their motion to dismiss the SAC.

[24] The signing of a Registration Statement, alone, is significant for the purposes of finding that a person is a statutory seller, particularly when (as Plaintiff does here) it is coupled with additional allegations. *See In re Vivendi Universal, S.A. Sec. Litig.*, 381 F. Supp. 2d 158, 187 (S.D.N.Y. 2003).

13-15, 17, 19-22, 175. Plaintiff has, through these allegations, adequately pled that each of the defendants passed title and/or solicited fund purchasers, motivated, at least in part, by a financial interest.

Accordingly, Plaintiff did not, as defendants contend, ***only*** allege that defendants signed the Registration Statements. Trustee Mem. at 1-2. For the same reason, defendants' reliance on Judge Sullivan's holding in *Citiline Holdings, Inc. v. iStar Financial, Inc*., 701 F. Supp. 2d 506 (S.D.N.Y. 2010) is misplaced. In *Citiline*, the Court was not presented with any facts other than "the individual defendants' signing of the registration statement itself" to impose liability under Section 12. *Id.* at 512. The allegations at issue in *Citiline* simply do not measure up to those plead by Plaintiff here.

D. Defendants Have Not Established that Their Loss Causation Affirmative Defense Will Prevail as a Matter of Law

Defendants next assert that dismissal is warranted because loss causation is "absent" from the SAC. *See* Def. Mem. at 22-30. Loss causation, however, is not an element of a §11 or a §12(a) claim and need not be pleaded to sufficiently state a claim. *See* 15 U.S.C. §77k; 15 U.S.C. §77l; *Briarwood Investments Inc. v. Care Inv. Trust Inc.*, No. 07 civ. 8159(LLS), 2009 WL 536517, at *3 (S.D.N.Y. Mar. 4, 2009) ("A plaintiff is not required to plead 'loss causation' . . . to establish a prima facie claim under §§11 or 12(a)(2) of the Securities Act.").[25] This Court has previously held

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[25] The same analysis for pleading loss causation, set forth below, applies to both §11 and §12(a)(2). *See, e.g., In re Morgan Stanley Tech. Fund Sec. Litig.*, Nos. 02 Civ. 6153(BSJ), 02 Civ. 8579(BSJ), 2009 WL 256005, at *6 (S.D.N.Y. Feb. 2, 2009) ("The PSLRA added an affirmative defense [for claims arising under Section 12(a)] modeled after Section 11 of the Securities Act."). In contrast, *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336 (2005) ("*Dura*"), *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161 (2d Cir. 2005), and most other cases cited by defendants, were private actions brought under the Securities Exchange Act of 1934 (the "the Exchange Act") – not the Securities Act. Under the Exchange Act, a plaintiff must affirmatively plead loss causation. *See, e.g., Dura*, 544 U.S. at 342. Significantly, the PSLRA, which dramatically changed the pleading landscape under the securities laws, amended both the Exchange Act and the Securities Act. It codified a loss causation element under §10(b) of the Exchange Act, explicitly placing on the plaintiff the burden of

that, unlike in a §10(b) action, "plaintiffs have no obligation to plead or prove loss causation in §11 cases . . .; rather, causation is presumed." *See AtriCure I*, 508 F. Supp. 2d at 273.[26]

While defendants acknowledge that establishing a negative loss causation defense is their burden, they attempt to sidestep this requirement by asking the Court to rule, as a matter of law, that there can never be loss causation in a mutual fund action absent proof that the NAV itself was misreported. Def. Mem. at 24-25. Stated differently, defendants claim that loss causation may only be established under the "misstatement—>price inflation—>truth—>stock price drop," "corrective disclosure" paradigm of fraud-on-the-market securities cases. *Id.* Defendants contend that a mutual fund's NAV does not react to positive or negative news (via open market trading), but only to the value of the underlying holdings, so they claim there can be no loss causation related to the misstatements alleged by Plaintiff. *Id.*; *but see In re Mutual Funds Inv. Litig.*, 590 F. Supp. 2d 741, 748 (D. Md. 2008) (citing *Dura*, 544 U.S. at 346) (noting that "in *Dura*, the Supreme Court did not indicate that the 'truth, then price drop' model is the only test for loss causation. To the contrary . . .

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proving loss causation, 15 U.S.C. §78u-4(b)(4); *Dura*, 544 U.S. at 342. However, while the PSLRA also amended the pleading laws under the Securities Act, it left totally undisturbed the defendant's burden to prove loss causation. *See* 15 U.S.C. §77z-1, *et seq*.

26 Relying on the holding in *In re Merrill Lynch & Co. Inc. Research Reports Sec. Litig.*, 289 F. Supp. 2d 429 (S.D.N.Y. 2003) ("*Merrill Lynch II*"), defendants argue for dismissal and assert that, on the face of the SAC, plaintiff will never be able to demonstrate loss causation. The court in *Merrill Lynch II* held, based on that court's earlier decision that year involving similar facts in *In re Merrill Lynch & Co. Inc. Research Reports Sec. Litig*., 272 F. Supp. 2d 243, 255 (S.D.N.Y. 2003) ("*Merrill Lynch I*"), that the plaintiffs could not prove loss causation because the security in question declined before the disclosure of the allegedly omitted information. This Court, however, has previously rejected a similar attempt to impose a loss causation pleading requirement to a §11 claim based on the holding in *Merrill Lynch I*. *See AtriCure I*, 508 F. Supp. 2d. at 272. As noted in *AtriCure I*, the opinion in *Merrill Lynch I* cited to no other cases in which a Rule 12(b)(6) motion to dismiss was granted based on the absence of loss causation in a §11 claim and that "the decisions relied on [by that court] were all distinguishable – either made on motions for summary judgment or after trial or involving claims where the burden of proving loss causation fell on the plaintiff." *Id.* at 273.

'[it did] not consider other proximate cause or loss-related questions.'"); *Siemers v. Wells Fargo & Co.*, No. C 05-04518 WHA, 2007 WL 760750, at *14 (N.D. Cal. Mar. 9, 2007) (it is unnecessary to show a drop in NAV after the truth is revealed to establish loss causation in a mutual fund case).

Defendants' argument ignores established Second Circuit authority, as well as the reasoned opinions of courts throughout the country. Tellingly, defendants do not cite a single case adopting their radical position. In this Circuit, "a misstatement or omission is the 'proximate cause' of an investment loss if the risk that caused the loss was within the zone of risk *concealed* by the misrepresentations and omissions alleged by a disappointed investor." *Lentell*, 396 F.3d at 173 (emphasis in original); *accord In re Omnicom Group, Inc. Sec. Litig.*, 597 F.3d 501, 510 (2d Cir. 2010) (noting that the Second Circuit in *Lentell* adopted the "zone of risk" test). "The zone of risk is determined by the purposes of the securities laws, *i.e.*, 'to make sure that buyers of securities get what they think they are getting.'" *Omnicom Group*, 597 F.3d at 513 (quoting *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 943 (2d Cir. 1984)).[27]

Here, Plaintiff's allegations that the Registration Statements misrepresented the Fund and the related risks associated with the undisclosed, over-concentration in the mortgage industry, fall squarely into this rubric. When this considerable risk (of which its nature and magnitude were obfuscated by defendants) materialized, Plaintiff and the putative class suffered significant losses. *See, e.g.*, *IKB Deutsche*, 2010 WL 1702196, at *3 ("Drawing all reasonable inferences in the

[27] As discussed above, a corrective disclosure of the nature sought by defendants is not required to defeat a loss causation defense. *See Dura*, 544 U.S. at 346; *see also Freudenberg v. E*Trade Fin. Corp.*, No. 07 Civ. 8538, 2010 WL 1904314, at *27-*28 (S.D.N.Y. May 11, 2010) (a corrective disclosure is not required; "the materialization of concealed risks and information regarding the quality of E*TRADE's mortgage investments sufficed to plead loss causation."); *Alaska Elec. Pension Fund v. Flowserve Corp.*, 572 F.3d 221, 230 (5th Cir. 2009) ("If a fact-for-fact disclosure were required to establish loss causation, a defendant could defeat liability by refusing to admit the falsity of its prior misstatements").

plaintiffs' favor, the risk that caused plaintiffs' losses – that Rhinebridge consisted of toxic assets that would become worthless – was precisely within the zone of risk concealed by the Top Ratings.").

Again, Plaintiff alleges that the Registration Statements were materially false and misleading because they misrepresented the nature of the securities or investments held by the Fund, misrepresented the description and objectives of the Fund, and understated the Fund's true and massive exposure to high risk mortgage-related securities, including subprime mortgage securities. ¶¶9, 70-118. Internal State Street documents reveal that even though State Street told investors that mortgage-backed securities comprised between 13% to 16.9% of the Fund's portfolio, those securities actually represented as much as 72.86% to 86.71% of the Fund. ¶¶71, 73, 77. Significantly, defendants failed to disclose that the Fund had a significant exposure to risky subprime mortgage securities amounting to 22.34% to 28.05% of the Fund's holdings. ¶42. Plaintiff also alleges that, contrary to the Registration Statements, the Fund did not invest in a "diversified portfolio" of debt securities but invested mostly in mortgage-related securities, making the Fund riskier than represented. ¶¶119-25. Additionally, Plaintiff alleges that contrary to the Fund's investment objective of seeking "liquidity," the Fund was heavily invested in mortgage-related securities that were either illiquid or at risk of becoming illiquid. Finally, Plaintiff alleges the Registration Statements misrepresented that the Fund would invest in "high quality" securities. ¶¶134-40. Plaintiff alleges that the concealed risks materialized when defendants wrote down the market value of the Funds' mortgage-related investments, causing "a commensurate decline in the Fund[s'] NAV, which in turn resulted in losses and caused investors to abandon the Fund." ¶¶149-51. The misrepresentations about the description, objectives, composition, diversification, liquidity and quality of the Fund concealed the true nature and risk of the Fund and caused (or

exacerbated) the losses to Plaintiff and other members of the Class after the risk materialized. ¶¶70, 124, 127, 133, 140, 149-57.

Defendants also ignore Plaintiff's allegations that the heavy emphasis on mortgage-related securities, which caused a decline in the Fund's NAV, resulted in further declines in the NAV in the form of a "run on the Fund" by investors and eventual liquidation of the Fund. ¶¶149-58 Plaintiff alleges that the write-downs of the Fund beginning in 2007 and continuing into 2008 "caused investors to abandon the Fund." ¶149. It was during this period that investors began to learn about the Fund's large bet on the mortgage market. ¶¶152-54. The revelation of these facts caused investors to liquidate their shares of the Fund in mass, causing pressure on the Fund to liquidate securities at a time when the mortgage-related securities market had already experienced a significant decline and was illiquid. This abandoning of the Fund caused additional losses and resulted in the liquidation of the Fund on May 30, 2008. ¶158. *Mutual Funds*, 590 F. Supp. 2d at 748 (recognizing loss causation regarding "flight damages.").

Several recent court opinions with similar fact patterns have addressed and rejected the very same arguments advanced by defendants here. Relying in part on *Lentell,* the court in *Charles Schwab I* found:

> Defendants reasoning is as follows. Plaintiffs are investors in a mutual fund rather than in an individual security. The price of shares in a mutual fund – the fund's net asset value – is determined entirely by the value of the assets in the fund's portfolio. . . . Thus, even if the fund misrepresented its investment policies and/or risk profile, those misrepresentations could not have caused plaintiffs' losses because the misrepresentations did not cause the decline in the value of the portfolio's asset holdings.
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> * * *
>
> Defendants' narrow formulation of loss causation would effectively insulate mutual fund companies from claims for a wide range of material misrepresentations regarding fund policies, risks and investment decisions. Defendants would immunize a scheme that purported to invest in low-risk government bonds but in fact invested

> in legitimate but high-risk treasure-hunting expeditions. ***Loss causation, however, is not limited to the common "corrective disclosure-price drop" scenario.***
>
> As courts in other circuits have explained, ***a plaintiff may establish loss causation by alleging "that the subject of the fraudulent statement or omission was the cause of the actual loss suffered;" that defendants' "misstatements and omissions concealed the price-volatility risk (or some other risk) that materialized and played some part in diminishing the market value of" the security***. *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 173, 177 (2d Cir. 2005) (citation omitted; emphasis in original).

257 F.R.D. at 547; *see also Castillo v. Dean Witter Discover & Co.*, No. 97 Civ. 1272(RPP), 1998 WL 342050, at *6 (S.D.N.Y. June 25, 1998) (citing *Brushi v. Brown,* 876 F.2d 1526, 1531 (8th Cir. 1989)) ("Courts have found that the requirement of loss causation is satisfied where the misrepresentations made by the defendant are related to the losses suffered by the plaintiff, as in a case where the plaintiffs loss results from the risky nature of the investment and the defendant induced the plaintiff to enter into that risky transaction by misrepresenting it as safe.").

Similarly, the court in *In re Evergreen Ultra Short Opportunities Fund Sec. Litig.*, 705 F. Supp. 2d 86 (D. Mass. 2010) recently rejected the same mutual fund loss causation argument advanced by defendants here as "too narrow" and reiterated that loss causation is not limited to the common 'corrective-disclosure-price drop' scenario. *Id.* at 95 (citing *Charles Schwab I,* 257 F.R.D. at 547); *see also id*. ("the plaintiffs allege that the defendants made false representations about the riskiness of the Fund's investments. . . . When the defendants' alleged misstatements were ultimately revealed, the NAV declined in value, resulting in losses to the Fund.").

Even more recently, the court in *IKB Deutsche* rejected a similar argument that the complaint failed to plead loss causation under a fraud claim in connection with the decline of a structured investment vehicle named Rhinebridge. 2010 WL 1702196, at *1. The plaintiffs alleged that the defendants misrepresented the safety, risk and likelihood of default of the investments held by Rhinebridge. *Id*. Judge Schleindlin held that the risk that caused plaintiffs' losses – that

Rhinebridge consisted of toxic assets that would become worthless – was within the zone of risk concealed by the defendants. *Id*. at *14-*15. In support of its holding, the court quoted a hypothetical raised in *Charles Schwab II*, which was premised upon the Second Circuit's *Lentell* opinion:

> [I]f a mutual fund holds itself out as investing no more than 25 percent in a single industry but then, as actually planned, invests fifty percent in a single industry, there is no escape by blaming the industry [upon its decline] rather than the promoter. The materialization of the concealed risk causes the loss.

Id. at *5 (quoting *Charles Schwab II*, 2010 WL 1463490, at *6 (citing *Lentell*, 396 F.3d at 172)); *see also Louros v. Kreicas*, 367 F. Supp. 2d 572, 583, 592-93 (S.D.N.Y. 2005) (citing *Lentell*, 396 F.3d at 173) ("A reasonable jury could find that the June Spreads created the risk that [plaintiff] could lose nearly all of the money in the Schwab Taxable Account if the market dipped. It could determine further that Misrepresentations (3) and (5)(a) [regarding the conservative nature of the investment] . . . concealed this risk and that it was precisely this risk that materialized and that culminated in . . . a loss"); *Owens v. Gaffken & Barriger Fund, LLC*, No. 08 Civ. 8414, 2009 WL 3073338, at *8 (S.D.N.Y. Sept. 21, 2009) (holding loss causation adequately pleaded where defendant's misstatements concealed from a plaintiff seeking a low-risk investments that he was investing in a fund comprised largely of unstable commercial real estate loans and plaintiff suffered losses when the investment declined in value as a result).

As the *Charles Schwab I* court pointed out, the narrow formulation of loss causation advocated by defendants here would "insulate mutual fund companies from claims for a wide range of material misrepresentations regarding fund policies, risks and investment decisions." *Charles Schwab I*, 257 F.R.D. at 547. Defendants attempt to minimize this important point by asserting that other forms of liability exist for mutual funds. *See* Def. Mem. at 28-30. Those cases, however, are inapposite and unrelated to Plaintiff's claims since they focus on claims brought under §10(b) of the

Exchange Act, deal with excessive fees, or involve actions brought by the SEC for fraud.[28] Furthermore, the ability of the SEC to file claims for fraud under §17(a) of the Securities Act or §10(b), or that certain types of unrelated claims can be brought under the Investment Company Act and Investment Advisers Act, do not eliminate the need for private litigation under the Securities Act. The SEC has limited resources and private actions play an important role in enforcing the federal securities laws. *See Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 313 (2007) ("This Court has long recognized that meritorious private actions to enforce federal antifraud securities laws are an essential supplement to criminal prosecutions and civil enforcement actions brought, respectively, by the Department of Justice and the Securities and Exchange Commission (SEC)."). Defendants cannot seriously dispute that accepting their argument would all but extinguish the rights of investors who have been harmed by misleading statements about the investment objectives, holdings, and other material information that investors deem critical when evaluating and understanding a mutual fund.

At the summary judgment stage, defendants will have the opportunity to provide expert testimony in an effort to prove that the declines in the Fund's NAV were unrelated to defendants' misrepresentations or the "run on the Fund" by investors that coincided with the revelations of the

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[28] *Operating Local 649 Annuity Trust Fund v. Smith Barney Fund Mgmt. LLC*, 595 F.3d 86, 93 (2d Cir. 2010) (excessive fees case under §10(b)); *In re AIG Advisor Group*, No. 06CV1625(JG), 2007 WL 1213395, at *11 (E.D.N.Y. April 25, 2007) (plaintiffs allege that defendants engaged in fraudulent kickback scheme along with Securities Act claims and the Court held that pleaded loss causation with respect to excessive fees); *SEC v. Lee*, No. 08-CV-9961, 2010 WL 2594280, at *1; *24 (S.D.N.Y. June 18, 2010) (stating that the four involved actions "stem from a fraudulent scheme"). Defendants also assert that the SEC can bring enforcement actions under §17(a) of the Securities Act and §10(b) of the Exchange Act against mutual fund without proving loss causation but both of those sections are based on fraud and do not preclude a private action under the Securities Act.

Fund's significant exposure to mortgage-related securities. *AtriCure I*, 508 F. Supp. 2d at 274. Defendants, however, have simply not satisfied their burden at this stage in the litigation.

E. Should the Court Dismiss Any Portion of the SAC, Plaintiff Should Be Afforded the Right to Replead

In the event that the Court grants dismissal of any portion of the Complaint, Plaintiff respectfully requests an opportunity to amend the Complaint. *See Cortec Inds., Inc. v. Sum Holding L.P.*, 949 F.2d 42, 48 (2d Cir. 1991) ("It is the usual practice upon granting a motion to dismiss to allow leave to replead."). Given the opportunity, Plaintiff can bolster his allegations concerning the false and misleading disclosures made in the Registration Statements, including descriptors of the Fund (*e.g.*, investments in high quality security, liquidity of the Fund's underlying securities, and the overall diversification of the Fund's portfolio). Among other facts and information, Plaintiff can expound upon the improper sectoring of certain securities in the Registration Statement, which resulted in the miscategorization of MBS as safer, less risky, investments.

V. CONCLUSION

Because Plaintiff has pleaded a plausible claim that the Registration Statements were materially false and misleading, and defendants have failed to establish their negative causation defense, Plaintiff respectfully submits that defendants' motions to dismiss should be denied in their entirety.

DATED: October 12, 2010

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CERTIFICATE OF SERVICE

I, Evan J. Kaufman, hereby certify that on October 12, 2010, I caused the foregoing:

Plaintiff's Memorandum of Law in Opposition to Defendants' Motions to Dismiss the Second Amended Class Action Complaint; and

Declaration of Evan J. Kaufman in Support of Plaintiff's Memorandum of Law in Opposition to Defendants' Motions to Dismiss the Second Amended Class Action Complaint

to be electronically filed with the Clerk of the Court using the CM/ECF system, which will send notification of such public filing to all counsel registered to receive such notice.

/s/ Evan J. Kaufman
EVAN J. KAUFMAN